

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

A REVIEW OF THE RATES AND CHARGES)	
AND INCENTIVE REGULATION PLAN OF)	CASE NO. 90-256
SOUTH CENTRAL BELL TELEPHONE COMPANY)	

O R D E R

BACKGROUND

On September 30, 1988, the Commission issued an Order in Case No. 10105¹ approving an experimental incentive regulation plan for a period of 2 years. In that Order the Commission stated that at the end of the 2-year trial period, South Central Bell Telephone Company, Inc. ("SCB") would be required to file a rate case and the Commission would concurrently evaluate the results of the experimental incentive regulation plan to determine if incentive regulation was in the public interest and should be continued.

To assist in the review of the incentive regulation plan, the Commission initiated an audit of the plan and its results through an independent consulting firm, Theodore Barry & Associates ("TB&A"). TB&A's Incentive Regulation Review Report ("TB&A Report") was released to the public on September 4, 1990. On September 6, 1990, the Commission initiated this investigation and SCB was directed to file testimony and certain financial data.

¹ Case No. 10105, Investigation of the Kentucky Intrastate Rates of South Central Bell Telephone Company, Inc.

SCB filed its testimony on October 17, 1990, and additional financial information will be filed by November 1, 1990.

The Attorney General, by and through his Utility and Rate Intervention Division ("AG"), MCI Telecommunications Corporation, Inc. ("MCI"), GTE South Incorporated ("GTE South"), and AT&T Communications of the South Central States, Inc. ("AT&T") are intervenors in this proceeding.

On October 1, 1990, SCB filed a motion to adopt a revised incentive regulation plan and to defer rate design. SCB concluded that the experimental incentive regulation plan had met or exceeded the objectives outlined in Case No. 10105 and that this investigation should be concluded and incentive regulation continued by incorporating certain modifications recommended in the TB&A Report. SCB suggested that the capital markets be reviewed to validate the existing returns on capital which trigger the various sharing ranges. SCB also suggested that rate design issues be deferred until the conclusion of Administrative Case Nos. 285² and 323.³ SCB claimed the experimental plan had provided a number of benefits, including rate reductions, fair and reasonable company earnings, continued quality of service, enhanced Commission oversight and efficient regulation. Based

² Administrative Case No. 285, The Investigation Into The Economic Feasibility of Providing Local Measured Service Telephone Rates in Kentucky.

³ Administrative Case No. 323, An Inquiry Into IntraLATA Toll Competition, An appropriate Compensation Scheme For Completion Of IntraLATA Calls By Interexchange Carriers, and WATS Jurisdictionally.

upon these claims, SCB argues that a review of incentive regulation in the context of a rate case is not necessary.

On October 8, 1990, MCI filed a motion requesting that a procedural schedule be adopted and asked for clarification of the role of TB&A.

On October 10, 1990, MCI filed a response to SCB's motion to adopt a revised incentive regulation plan and defer rate design. MCI raised objection to allowing the incentive plan to continue in effect without giving the parties an opportunity to present evidence through an orderly procedure allowing due process. On October 15, 1990, SCB replied to MCI's response stating that MCI mischaracterized SCB's October 1, 1990 motion. SCB stated that it fully expected the Commission to conduct hearings on the incentive plan and to give the parties an opportunity to be heard. SCB again stated that the Commission should defer the issue of rate design to a later date.

DISCUSSION

A procedural schedule is established to expedite this investigation. It is best to separate rate design issues and hear evidence on those issues at a later date. The procedural schedule, attached hereto and incorporated herein as Appendix A, should be followed in Phase I of this investigation. The evidence to be considered in Phase I will include: (1) the appropriateness of continuing incentive regulation for SCB; (2) specific modification to the incentive plan as outlined in the TB&A Report; (3) other modifications to the plan as outlined in the succeeding

section of this Order; and (4) any modifications proposed by the parties.

For purposes of clarification, the TB&A Report will be considered as part of the evidence in this case. As such, the report will be subject to comment and challenge by the Commission and the parties. TB&A will be required to be available for cross-examination in hearings. The TB&A Report will be treated as prefiled testimony.

The Commission will defer a procedural schedule to a later phase of this proceeding on other issues until after a decision is rendered with respect to continuing incentive regulation of SCB.

In addition to the modifications included in the TB&A Report, evidence should be presented on the following items and should be considered and reviewed in the case:

- A. Should the plan be continued for a period of 3 years on and after October 1, 1990?
- B. Should some measure of productivity be incorporated in the incentive plan? If so, what measure should be included and how should it be incorporated as a part of the plan?
- C. Rate Base and Capital
 - 1. Should SCB-Kentucky's investment in BellSouth Services be removed from rate base and capital?
 - 2. Should "Telephone Plant Under Construction" and "Telephone Property Held For Future Use" not expected to be used and useful within one year of

the 12-month period be removed from rate base and capital?

3. Should the Kentucky Commission's methodology for determining rate base and allocation of capital based on rate base be used in lieu of SCB's allocation methodology?

D. Adjustments to Earnings at each Point of Test

Revenues

1. Whether to impute revenues for the following items:
 - a. Employee concession service allowed during the period. If yes, should this amount include directly incurred concession service given to any past or present employees of SCB-Kentucky or any past or present employees of BellSouth Services, BellSouth Corporation, or any other affiliates billed to SCB-Kentucky?
 - b. Additional BellSouth Advertising and Publishing Company ("BAPCO") royalty fees to SCB-Kentucky, based upon restricting BAPCO and any company which derives more than 80 percent of its gross revenue from BAPCO, to the intra-state return on capital allowed SCB-Kentucky.

Expenses

1. Whether to remove from expenses all of the following, regardless of whether incurred directly or billed to SCB-Kentucky:
 - a. Memberships in social, service, or professional organizations or clubs including country club dues and initiation fees and health club dues.
 - b. Contributions of any nature.
 - c. All advertising expenses, unless it can be demonstrated that the expenditures are allowable under 807 KAR 5:016. Should expenditures not removed from expenses be individually supported as allowable?
 - d. Expenses attributable to the Atlanta Golf Classic or any other sponsorship of similar events.
 - e. Expenses associated with administration of the BellSouth Foundation.
 - f. All expenses of BellSouth D.C.
 - g. Any lease expenses associated with the Campanile Building in Atlanta, the Colonnade complex in Birmingham, or any other building leased from any affiliated company. Should these expenses be removed if it can be demonstrated that the leasing arrangements

satisfy the costing rules in Part 32 of the FCC's Rules and Regulations?

h. Any expenses associated with the BellSouth building at the Inforum in Atlanta.

i. Any expenses that can be classified as:

1) Trust asset expense.

2) Corporate governance expenses related to shareholder services.

3) Corporate auditing expenses not directly associated with SCB-Kentucky audits.

4) Public relations expenses related to employee communications, planning, and research; publication of the quarterly newsletter and similar publications; any other expenditures related to shareholder and employee information or communications.

5) Expenses of Public Relations-D.C., public relations advertising and corporate office expenses related to the annual shareholders' meeting or related to community affairs.

E. Capital Structure, Return on Equity, and Sharing Ranges

1. Whether the capital structure used should be capped at a set equity ratio or whether actual capital structure should be used.

2. Whether the return on equity or return on capital should be used.
3. Whether the return on equity should be set to reflect current capital costs.
4. Whether subsequent review of capital markets should be performed annually.
5. What neutral range should be prescribed above and below the allowed return on equity or capital? Should ratepayers and stockholders share earnings in excess of any prescribed neutral range? What should the level of sharing be? Should there be a ceiling above which no sharing is permitted?
6. Should the ratepayers and stockholders bear any underearnings below the prescribed neutral range? Should this be equal to any sharing range above the neutral level? Should there be a floor below which increases will be automatic?
7. Whether there should be any adjustments to earnings for prior period reductions or increases, sometimes referred to as "ratcheting."

F. Service Performance Levels

1. What modifications to the incentive plan would encourage SCB to make the necessary capital improvements to maintain adequate basic telephone services, especially to reduce the number of held orders or regrade requests, in situations where capital improvements may not be profitable?

2. What modifications to the incentive plan would encourage SCB to ensure that adequate quality of service standards are maintained? Should the Commission monitor quality of service through its existing reporting requirements, or should the Commission consider other standards to measure customer satisfaction with quality of service?
 3. Whether SCB's service performance should be monitored on an exchange-by-exchange basis, rather than on a company-wide basis.
 4. Whether the sharing ranges or percentage of sharing should be modified to reflect any change in SCB's service quality levels.
- G. Should SCB implement the 27 recommendations included in Chapters V through XI of the TB&A Report as a part of monitoring the incentive regulation plan? This implementation will require SCB to prepare action plans in the format prescribed by the Commission's Management Audit Branch and submit progress reports to the Commission at each point of test.
- H. Should the monies from the net effect of the 1990 depreciation resubscription and the extinguishment of the inside wire amortization January 1, 1991, and the monies from the effect of the end of the amortization of the depreciation reserve deficiency ending as of September 30, 1991, be given entirely to ratepayers via a flow-through mechanism? If so, should this be done at

the nearest point(s) of test as a part of the incentive regulation plan or separately on or near the respective dates?

- I. Whether all other aspects of the incentive plan should be continued as prescribed in the Commission's Orders in Case No. 10105 and as modified in the TB&A Report.

SUMMARY

The Commission, being otherwise sufficiently advised, HEREBY ORDERS that:

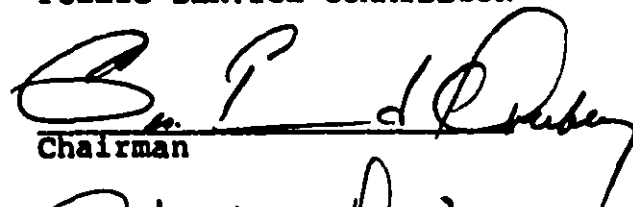
1. The procedure in Phase I as contained in Appendix A shall be followed for adequate consideration of SCB's motion to continue incentive regulation and modifications to the experimental incentive regulation plan.

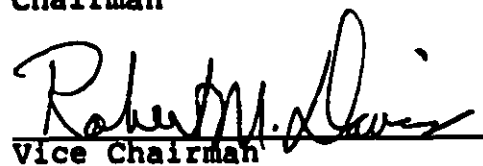
2. Other issues, including the possible need for a rate case, and all rate design issues related to the incentive regulation plan, will be deferred until Phase I is completed.

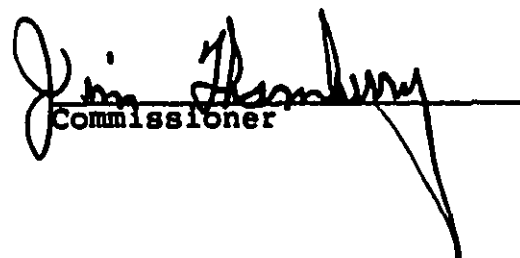
3. For review of the methodology of calculation, SCB shall file workpapers showing all calculations for the 12 months ending June 30, 1990 for all items listed above as adjustments to rate base, capital, or earnings within 10 days of the date of this Order.

Done at Frankfort, Kentucky, this 25th day of October, 1990.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director

APPENDIX A

**APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 90-256 DATED OCTOBER 25, 1990**

Procedural Schedule

Phase I

**Information Requests Due to SCB
and Theodore Barry & Associates November 16, 1990**

**Responses to Information Requests
Due From SCB and Theodore Barry &
Associates. Additionally, should
SCB want to prefile further
testimony, it may do so. November 26, 1990**

Parties to Prefile Testimony December 10, 1990

**Information Requests Due on
Parties' Prefiled Testimony December 28, 1990**

**Responses to Information Requested
on Prefiled Testimony Due January 11, 1991**

**Public Hearings are to begin at 10:00 a.m.,
Eastern Standard Time, in the Commission's
offices at Frankfort, Kentucky, for the
purpose of cross-examination of witnesses
of South Central Bell, cross-examination
of witnesses of intervenors and Theodore
Barry & Associates, and the presentation
of rebuttal testimony, if any January 22, 1991**